DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS NUMBER 00-0256
FINANCIAL INSTITUTIONS TAX
For the Tax Years 1996 and 1997

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ISSUE

I. Taxpayer's Qualifications to File Under Indiana's Financial Institutions Tax.

Authority: IC 6-5.5 et seq.; IC 6-5.5-1-17(d)(1); IC 6-5.5-1-17(d)(2)(A), (B); IC 6-5.5-3-1; 45 IAC 17-2-1(a); 45 IAC 17-2-4(b); 45 IAC 17-2-4(b)(1); 45 IAC 17-2-4(b)(2); 45 IAC 17-2-4(b), (c); 45 IAC 17-2-4(b)(1)-(3); 45 IAC 17-2-4(d)(1), (2); 45 IAC 17-2-4(e)(1); 45 IAC 17-2-4(e)(2); Rev. Rul. 55-540, § 162(4) 1955-2 CB 39; Rev. Proc. 75-21, § 4, 1975-1 CB 715.

Taxpayer protests the determination, contained within the original Letter of Findings, that taxpayer did not qualify to file under Indiana's Financial Institutions Tax. That determination affirmed the audit's previous decision to change taxpayer's filing status from a FIT-20 status to that of an IT-20 regular filer.

Statement of Facts

Taxpayer is in the business of leasing and financing the purchase of construction equipment and engines. Taxpayer does this by entering into various forms of transactions between itself, taxpayer's local dealerships, municipalities, or individual customers. The taxpayer is a Delaware Corporation headquartered in Illinois.

A hearing was originally held on the issues raised by taxpayer, a determination was reached that taxpayer did not qualify to file under the Financial Institutions Tax, and a Letter of Findings to that effect was issued by the Department. The taxpayer requested and was granted an opportunity for a rehearing during which the taxpayer presented documentary evidence purporting to establish that the taxpayer was qualified to file under the Financial Institutions Tax. This Supplemental Letter of Findings revisits the issue.

I. Taxpayer's Qualifications to File Under Indiana's Financial Institutions Tax.

DISCUSSION

Taxpayer's protest initially stemmed from audit's decision to change the taxpayer's filing status from that of an FIT-20 filer to an IT-20 filer. Audit made this decision because it determined that taxpayer did not provide sufficient proof to demonstrate that taxpayer's leases – transactions around which taxpayer's business is centered – were true financial leases. The taxpayer disagreed and continues to disagree with that conclusion. The taxpayer maintains that, because of the particularized manner in which conducts its business of leasing and financing the purchase of construction equipment, it comes within the definition of a financial institution pursuant to 45 IAC 17-2-4(d)(1), (2).

Taxpayer makes this claim for two reasons. First, the taxpayer argues that, pursuant to 45 IAC 17-2-4(d)(1), it is conducting the business of a financial institution because it is "extending credit." *See also* 45 IAC 17-2-4(e)(1). Second, the taxpayer argues that, pursuant to 45 IAC 17-2-4(d)(2), it undertakes leasing transactions which are "the economic equivalent of extending credit." Id. Taxpayer maintains that by accumulating those transactions which consist of extending credit together with those transactions which are the economic equivalent of extending credit, it reaches the 80 percent benchmark – set out in 45 IAC 17-2-4(b) – which allows it to claim FIT filing status.

Indiana imposes a franchise tax, known as the Financial Institution Tax (FIT), on corporations transacting the business of a financial institution inside the state. IC 6-5.5 et. seq. The FIT is imposed on resident financial institutions, nonresident financial institutions, and to certain non-bank entities that transact the business of a financial institution. 45 IAC 17-2-1(a). Non-resident corporations, such as the taxpayer, transacting the business of a financial institution, are included in the FIT, when they first meet one of the eight tests set out in IC 6-5.5-3-1 whereby the non-resident corporation demonstrates that it has established an economic presence in Indiana. It was not disputed at the time of the original Letter of Findings, and it is not disputed here, that taxpayer has established an economic presence in Indiana. That issue will not be revisited.

Because the taxpayer is not conducting the business of a traditionally regulated financial institution as defined in IC 6-5.5-1-17(d)(1), the taxpayer predicates its claim to FIT status under the provisions of IC 6-5.5-1-17(d)(2)(A), (B) which grant FIT status to those corporations which obtain 80 percent of their gross income from the "[m]aking, acquiring, selling, or servicing loans or extensions of credit" or from the "leasing [of] real and personal property that is the economic equivalent of the extension of credit if the transaction is not treated as a lease for federal income tax purposes"

The benchmark for determining whether a taxpayer is "conducting the business of a financial institution" is if 80 percent of the corporation's gross income is derived from the economic equivalent of extending credit. 45 IAC 17-2-4(b), (c). The taxpayer may reach this 80 percent benchmark in one of three ways. It may do so by deriving 80 percent of its income from "(1) Extending credit . . . (2) Leasing that is the economic equivalent of extending credit [or] (3) Credit card operations." 45 IAC 17-2-4(b)(1)-(3).

An explanation of "the economic equivalent of the extension of credit" is found within the Department of Revenue regulations. 45 IAC 17-2-4(b), (c). The corporation must not only derive 80 percent of its income from collecting interest, that interest must be derived from a lease that is "*not* treated as a lease for federal income tax purposes." 45 IAC 17-2-4(e)(2) (Emphasis added). Therefore, to satisfy the requisite 80 percent benchmark, the interest must be both "the economic equivalent of the extension of credit" and from a lease "*not* treated as a lease for federal income tax purposes."

The taxpayer, looking to reach the 80 percent benchmark by "[l]easing that is the economic equivalent of extending credit" (45 IAC 17-2-4(b)(2)) is required to demonstrate that the transactions from which it derives interest income are not true leases but financing leases. A financing lease appears on the surface to be a lease – and may be labeled as such – but in substance is simply a device which enables the lessor to retain a security interest in the property until the purchase price is paid by lessee. IRS Revenue Ruling 55-540 provides the guidelines used in determining the treatment of equipment leases for use in the trade or business of the lessee. Whether a lease agreement is a lease, or in reality a conditional sale (financing lease) depends on the provisions of the agreement in light of the facts and circumstances existing at the time the agreement was executed. Rev. Rul. 55-540, § 162(4) 1955-2 CB 39. In the "absence of compelling persuasive factors" demonstrating otherwise, a transaction is a conditional sales contract if one or more of the following factors are present.

(1) Portions of the periodic payments are specifically applicable to the equity to be acquired by lessee;

(2) the lessee acquires title upon a payment of a stated amount of rentals which under the contract the lessee is required to make,

(3) the total amount paid by the lessee for a relatively short period of use constitutes an inordinately large proportion of the total payments required to secure transfer of title,

(4) the rental payments materially exceed the fair rental value,

(5) the property can be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time the option may be exercised or which is a relatively small amount when compared to the total,

(6) some portion of the payments is specifically designated as interest or is otherwise recognizable as the equivalent of interest. Id.

IRS Revenue Procedure 75-21 expands on Revenue Ruling 55-540 by elaborating on the facts and circumstances that indicate whether a transaction is, in contrast to a conditional sale, a true lease. Such true leases may not be used by the taxpayer to reach the 80 percent benchmark because they are not the "economic equivalent of extending credit." A transaction will constitute a true lease if *all* of the following conditions are met;

(1) The lessor must have a minimum unconditional risk investment in the property at the inception of the transaction,

(2) the lessor must maintain the minimum at risk investment throughout the lease and that risk must remain at the end of the lease,

(3) the minimum at risk investment must be equal to at least 20% of the cost of the property and must remain at 20% throughout the entire lease term,

(4) and, there must be a residual investment of at least 20% at the end of the lease term. Rev. Proc. 75-21, § 4, 1975-1 CB 715.

Taxpayer conducts its business by means of seven different forms of transactions. For purposes of this discussion, these will be grouped into one of two different categories. "Qualifying Transactions" are those transactions which fall within the purview of 45 IAC 17-2-4(b)(1)-(3) and which can be accumulated to bring the taxpayer to the 80 percent benchmark required to qualify taxpayer as a FIT filer. "Non-qualifying Transactions" are those transactions which cannot be accumulated to bring the taxpayer to the 80 percent benchmark.

A. Non-Qualifying Transactions.

Taxpayer's first two forms of transactions are described by the taxpayer as "operating leases" and "conditional sales contracts." Taxpayer Information, Feb. 7, 2001, p. 1-2. These two forms of contracts are Non-Qualifying Transactions because they are not "the economic equivalent of the extension of credit." 45 IAC 17-2-4(b), (c). For the tax years at issue, these two transactions purportedly represent 6.66% and 6.75% of the taxpayer's gross income. Taxpayer Information, Feb. 7, 2001, Attachment A. Because the taxpayer does not assert, and because that assertion is not disputed here, the transactions are Non-Qualifying Transactions which do not assist the taxpayer in achieving the 80 percent benchmark needed to qualify for FIT status.

B. Qualifying Transactions.

Taxpayer bases its claim to FIT status on the remaining five transactional forms set out as follows. Taxpayer labels those purportedly Qualifying Transactions as; conditional sales contracts, installment sales, municipal sales, dealer/customer notes, and "other non-rental/lease income."

1. Conditional Sales Contracts

In taxpayer's conditional sales contracts, taxpayer purchases an item of equipment from one of its local dealers and simultaneously sells the machine to the customer by executing a "conditional sales contract" with the customer. This arrangement allows the customer to purchase the equipment at the end of contract for a nominal amount. Taxpayer describes

a “conditional sales contract” as a means by which the taxpayer finances a customer’s purchase of equipment. In a “conditional sales contract,” the customer owns the equipment but taxpayer maintains a security interest in the equipment during the term of the contract. Taxpayer provides a specific example of a “conditional sales contract.” Taxpayer Information, Feb. 7, 2001, Attachment D-1, D-2. In that example, the original cost of the equipment is $113,500. The customer makes 36 monthly payments of $3,794 with the total payments equaling $136,619. At the end of the three-year contract, the customer has the option to purchase the equipment for $1.00. Under Rev. Rul. 55-540, taxpayer’s “conditional sales contracts” are Qualifying Transactions” (conditional sales contracts) because; (1) the lessee acquires an equity interest in the equipment during the lease, (2) the customer acquires title to the equipment upon payment of a stated amount of rentals, (3) the amount paid by the customer constitutes an inordinately large proportion of the total payments required to secure transfer of the title, and (4) at the end of the lease, the equipment can be purchased by the customer at a bargain. Id. Accordingly, the taxpayer’s “conditional sales contracts” are Qualifying Transactions for the purposes of acquiring FIT status.

2. Installment Sales Contracts.

In an “installment sales contract,” one of taxpayer’s local dealers sells an item of equipment to a customer and enters into the “installment sales contract” with the customer. The taxpayer then purchases the “installment sales contract” from the local dealer. The “installment sales contract” is an arrangement by which the customer owns the equipment but taxpayer maintains an interest in that equipment as security for the customer’s obligations under the “installment sales contract.” Taxpayer has provided an example of a “installment sales contract.” Taxpayer Information, Feb. 7, 2001, Attachment E-1, E-2. Under the example, the original cost of the equipment is $221,845. The customer makes 60 monthly payments of $4,650 consisting of principal and interest. At the end of the 60 months, the customer has made total payments of $279,037. After the last monthly payment has been made, the taxpayer no longer has a security interest in the equipment. Under Rev. Rul. 55-540, taxpayer’s “installment sales contracts” are Qualifying Transactions because; (1) the customer acquires an equity interest in the equipment by means of the down payment and the monthly payments, (2) the customer acquires title upon a payment of a stated amount of rentals which the customer is required to make, (3) a portion of the payments is specifically designated as interest, and (4) portions of the monthly payments are specifically applied to the equity which is acquired by the customer. Accordingly, the taxpayer’s “installment sales contracts” are Qualifying Transactions for the purpose of acquiring FIT status.

3. Municipal Sales

In taxpayer’s “municipal sales” transactions, the customer is a municipality and the transaction itself is structured the same as a “conditional sales” contract. The taxpayer has provided an example of a “municipal sales” contract. Taxpayer Information, Feb. 7, 2001, Attachment F-1, F-2. In the example provided, the original cost of the equipment is $71,103 less a trade-in valued at $25,000. The municipal customer will make two annual

payments of $16,560 and a mandatory third payment of $1.00. The total principal and interest – including the down payment – is equal to $73,768. Upon receiving the third payment, the taxpayer no longer has a security interest in the equipment. Under Rev. Rul. 55-540, taxpayer's "municipal sales" contracts are Qualifying Transactions because; (1) portions of the periodic payments are specifically applicable to the equity to be acquired by the municipal customer, (2) the municipal customer acquires title upon a payment of a stated amount of rentals which the municipal customer is required to make, and (3) the equipment is acquired by the municipal customer for a price which is nominal when compared to the value of the equipment at the time the equipment is acquired. Accordingly, the taxpayer's "municipal sales" contracts are Qualifying Transactions for the purpose of acquiring FIT status.

4. Dealer/Customer Notes.

The taxpayer's "dealer/customer notes" are straightforward promissory notes entered into between the taxpayer and either one of the taxpayer's local dealers or directly with the customer. On occasion, the taxpayer will enter into a "dealer/customer note" by purchasing the promissory note from a third party. These "dealer/customer notes" are entered into for two purposes. The "dealer/customer" notes can be used by the local dealer to acquire working capital. Normally, the working capital is then used to provide the local dealer with a stock of readily available equipment. The "dealer/customer notes" can also be entered into with either a customer or a local dealer for the purpose of allowing either the customer or dealer to acquire a specific item of equipment. For whatever purpose, the equipment itself is irrelevant to the transaction. Taxpayer has provided an example of a "dealer/customer note." Taxpayer Information, Feb. 7, 2001, Attachment G-1, G-2, G-3. The "dealer/customer notes" are straightforward promissory notes and constitute "Qualifying Transactions" because they fall within the purview of 45 IAC 17-2-4(b)(1). The "dealer/customer notes" are extensions of credit by which the taxpayer acquires interest payments. The taxpayer is "extending credit" because, by means of the "dealer/customer notes" the taxpayer is "[m]aking, acquiring, selling, or servicing loans or extensions of credit . . . includ[ing] secured or unsecured consumer loans . . . [or] secured and unsecured commercial loans of any type." 45 IAC 17-2-4(e)(1). Accordingly, the "dealer/customer notes" are Qualifying Transactions for the purpose of acquiring FIT status.

5. Other non-rental lease income

The taxpayer has presented a amalgam of miscellaneous transactions which it has grouped under the category of "other non-rental lease income." For purposes of this discussion, these miscellaneous transactions are addressed separately. The first transactions consist of interest income earned on loans to related parties. These transactions are inter-company loan agreements. These inter-company loan agreements constitute Qualifying Transactions. Under 45 IAC 17-2-4(e)(1), the agreements constitute the business of "extending credit" because they constitute "secured and unsecured commercial loans of any type . . . (or) other transactions with a comparable economic

effect." Accordingly, the interest derived from inter-company loan agreements can be used to reach the 80 percent benchmark figure needed to attain FIT status.

The second miscellaneous transaction consists of "wholesale finance income." This income is derived from loans to the taxpayer's local dealerships for the purpose of acquiring inventory. These transactions are similar to "dealer/customer notes" and, therefore also constitute Qualifying Transactions for the purpose of allowing taxpayer to attain FIT status.

The third miscellaneous transaction taxpayer labels as "insurance finance income." These transactions are straightforward loans made to customers who have purchased, from one of the taxpayer's local dealers, an item of equipment. These loans are made to the customer to enable that customer to purchase insurance for that particular item of equipment. The insurance is necessary because the customer has entered into a purchase agreement – either with taxpayer, local dealer, or a third-party – whereby the agreement mandates the equipment be insured during the term of the purchase agreement. The interest represents income from a Qualifying Transaction because the income is the result of extending credit for "loans and extensions of credit include[ing] secured or unsecured consumer loans . . . ." 45 IAC 17-2-4(e)(1).

The fourth miscellaneous transaction taxpayer labels as "service fee income on securitizations." This income results when taxpayer markets to a third-party loans taxpayer previously entered into with various local dealers and customers. Although the taxpayer has sold a particular loan to a third-party, taxpayer continues to service the loan by collecting monthly payments and doing whatever necessary to enforce the terms of the original loan. From the point of view of the customer or local dealer, the transaction whereby taxpayer sold the loan to a third-party is entirely transparent. Customer and local dealer continue to deal directly with the taxpayer. The "service fee income on securitizations" is derived from the "spread" (difference) between what taxpayer collects from customer or local dealer and what the taxpayer then pays over to the third-party. As an example, taxpayer collects monthly payments from a customer or local dealer consisting of principal and 5 percent interest. Taxpayer, in turn, forwards to third-party the amount of principal and 4 percent interest. Taxpayer retains 1 percent interest for itself. The 1 percent retained interest represents, in the taxpayer's jargon, "service fee income on securitizations." The "service fee income on securitizations" does not represent income from a Qualifying Transaction. By marketing the original loans to a third-party, taxpayer has removed itself from the business of extending credit and places itself in the business of providing certain loan services on behalf of the third-party. It is the third-party who is extending credit. The taxpayer, now on the periphery of the original loan transaction, is in the business of providing services ancillary to the loan transaction itself.

The fifth miscellaneous transaction is described as "late charges and document fees." This is income earned by the taxpayer when payments for Qualifying Transactions are received late and income received for the preparation of documents related to those Qualifying transactions. The income derived from late charges and document fees

represents income from a Qualifying Transaction because the income is derived from the business of extending credit.

Taxpayer has submitted evidence purporting to establish that it derives at least 80% of its income from Qualifying transactions. As set out in the information provided by taxpayer, taxpayer's income from Qualifying Transactions constitutes approximately 93% of its income for both of the two relevant tax years. Taxpayer Information, Feb. 7, 2001, Attachment A. However, taxpayer misapprehends the basis upon which the 80% benchmark figure is calculated. The regulation provides that taxpayer "is deemed to be conducting the business of a financial institution and therefore subject to the FIT if eighty percent (80%) or more of the [taxpayer's] *gross income during the taxable year* is derived from . . . leasing that is the economic equivalent of the extension of credit . . . ." 45 IAC 17-2-4(b), (c) (Emphasis added). Even if the Department were to accept the taxpayer's specific characterizations of its interest income, using the taxpayer's "Total Income" as represented on line 11 of its 1996 and 1997 federal tax returns and disregarding the determination that "service fee income on securitizations" is not derived from a Qualifying Transaction, taxpayer's income from Qualifying Transactions represents approximately 59% and 64% of its gross income for the two tax years at issue. Alternatively, using taxpayer's gross receipts as a basis for calculating the FIT benchmark figure, taxpayer's income from Qualifying Transactions represents approximately 24% of its gross income for the two tax years at issue. No matter upon which basis the numbers are calculated, the percentages fall short of the 80% FIT benchmark. Taxpayer is not qualified to file under the state's Financial Institutions Tax.

FINDING

Taxpayer's protest is respectfully denied.